

GETTING FOCUSED ON ESG INVESTING

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THE MSCI ESG FOCUS INDEXES

As equity investors evaluate the risk and opportunities associated with environmental, social and governance (ESG) considerations, the challenge they face is how to integrate ESG into their investment process while maintaining equity-market-like exposure. The MSCI ESG Focus Indexes are designed to help investors address this investment problem, seeking to maximize its exposure to ESG¹ while exhibiting risk and returns similar to the underlying parent market-cap-weighted index.

TWO OBJECTIVES, ONE APPROACH: MARKET BETA + ENHANCED ESG PROFILE

Market-cap-weighted indexes have long been used as performance benchmarks and over the years have evolved into tools used to measure market beta. While a performance benchmark is broad and designed to represent the entire investable opportunity set, is it possible to create an ESG-oriented index with risk and return characteristics similar to those of an underlying market-cap-weighted index? To answer this question, we compare ESG Focus Indexes in two key markets, the U.S. and EAFE, to their underlying parent indexes.

The MSCI USA ESG Focus Index and the MSCI EAFE ESG Focus Index are constructed using the constituents of the market-cap-weighted MSCI USA Index and MSCI EAFE Index, respectively, as starting universes. Stocks involved in tobacco and controversial weapons, commonly viewed by investors as engaging in controversial activities, are excluded from the ESG Focus Indexes.² Once these stocks are removed, the index is optimized to maximize the ESG score while maintaining replicability and broad diversification at the country, sector and stock level. Depending on country or region, each ESG Focus Index has a targeted tracking error between 0.50% and 1.00%. Tracking error describes the degree to which a portfolio's performance deviates from the parent index. By keeping the tracking error within a narrow range, the ESG Focus Indexes work to maintain market-like characteristics while improving their ESG profiles.³

¹ ESG scores range from 0-10 and are derived from the MSCI ESG Ratings framework, which rates companies according to their exposure to industry-specific ESG risks and their ability to manage those risks relative to peers. The MSCI ESG Rating indicates how well a company manages environmental, social, and governance risks relative to industry peers.

² Please refer to Appendix 1: Tobacco and Controversial Weapons Exclusion Criteria of the [MSCI ESG Focus Index Methodology](#) for further detail.

³ Similar risk and return characteristics and an improved ESG profile were observed for the MSCI EM (Emerging Markets) ESG Focus Index over the same period from November 2010 to August 2018.

MSCI ESG FOCUS INDEXES VS. THEIR MARKET-CAP-WEIGHTED PARENT INDEXES

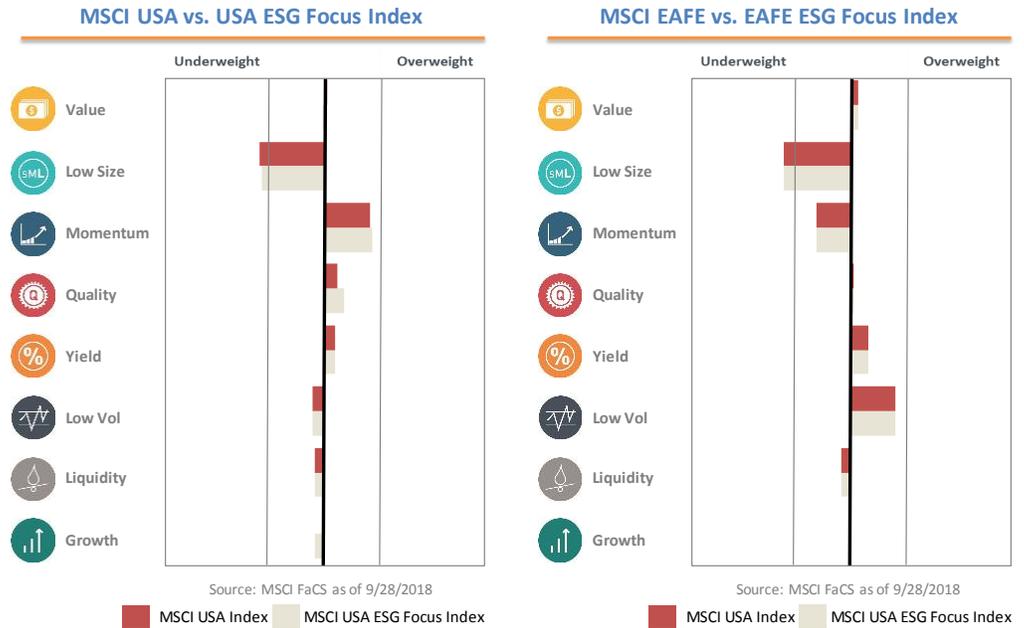
As we can see in the exhibits below, the ESG Focus Indexes generated similar levels of risk and return compared to their corresponding parent indexes, from November 2010 to August 2018, each with a tracking error of 0.60% and market beta of approximately 1.0, implying that over time the portfolios moved in line with the market. The factor exposures of each ESG Focus Index were similar to the parent indexes as well.

Risk and return of MSCI ESG Focus Indexes vs. their market-cap-weighted parent

	MSCI USA Index	MSCI USA ESG Focus Index	MSCI EAFE Index	MSCI EAFE ESG Focus Index
Total Return (%)	14.6	14.6	6.7	7.1
Total Risk (%)	10.8	10.8	13.6	13.7
Return/Risk	1.35	1.35	0.49	0.52
Sharpe Ratio	1.30	1.31	0.46	0.48
Active Return (%)	0.0	0.1	0.0	0.3
Tracking Error (%)	0.0	0.6	0.0	0.6
Information Ratio	NaN	0.16	NaN	0.56
Historical Beta	1.00	1.00	1.00	1.01
No of Stocks	615	319	922	417
Turnover (%)	1.7	16.5	1.8	21.6

Annualized Returns for Nov. 30, 2010 to Aug. 31, 2018

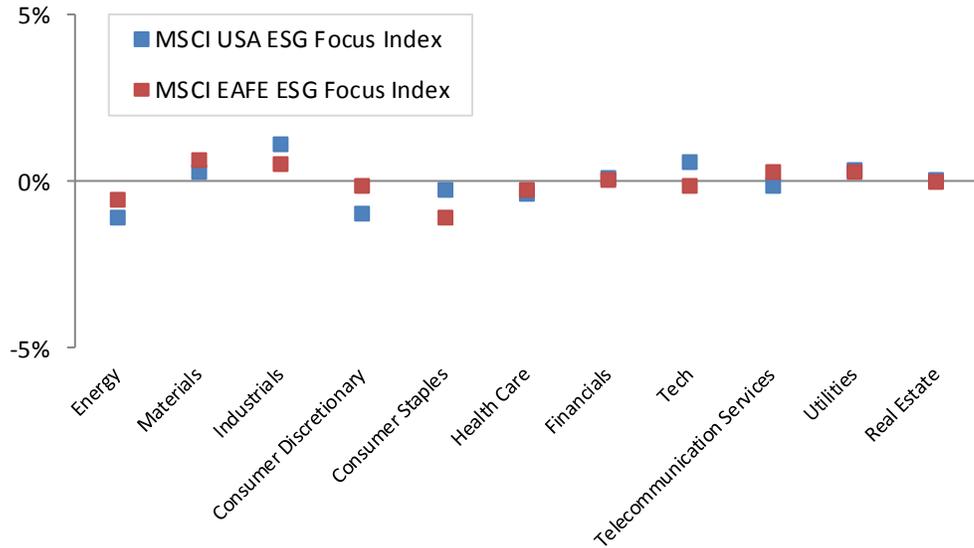
Factor exposures of MSCI ESG Focus Indexes vs. their market-cap-weighted parent



Looking deeper into the portfolios, on average, the MSCI USA ESG Focus Index and the MSCI EAFE ESG Focus Index contained 319 and 416 stocks, respectively, which equaled approximately 50% of the stocks held in their parent indexes. Nonetheless, on a historical basis, both ESG Focus Indexes had sector exposures comparable to those of their parent indexes, as seen in the exhibit below. This implies that the ESG Focus Indexes did not take significant sector bets relative to the underlying market.⁴

⁴ Please note that the changes to the GICS® structure, including the change in name from the Telecommunications Services Sector to the Communication Services Sector will be applied to MSCI Equity Indexes as part of the November 2018 Semi-Annual Index Review. GICS® is the global industry classification standard jointly developed by MSCI and Standard & Poor's.

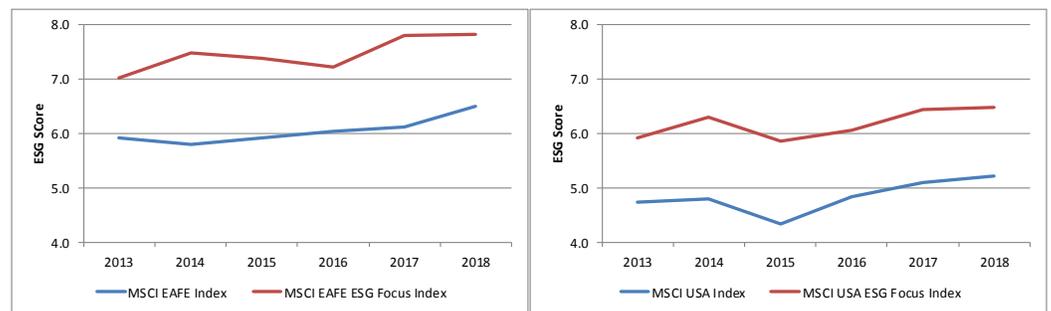
ESG Focus Indexes: Active sector weights



Average weighting from November 2010 to September 2018

Even though the ESG Focus Indexes maintained similar market-like profiles, they both improved ESG profiles by approximately 20%. As of Aug. 31, 2018, the average MSCI ESG Rating for the MSCI USA ESG Focus Index was 6.5 compared to 5.4 for the MSCI USA Index, and the MSCI EAFE ESG Focus Index averaged 7.7 compared to 6.6 for the MSCI EAFE Index. Over the period from December 2013 through May 2018, both ESG Focus Indexes consistently achieved average ESG scores well in excess of their parent indexes.

ESG Focus Indexes: ESG scores



Historical ESG Scores for the MSCI EAFE, and the MSCI USA Indexes over the period from December 2013 to May 2018

When compared to their corresponding market-cap-weighted indexes, both ESG Focus Indexes included roughly double the weight from ESG Leaders (stocks rated AA to AAA) and significantly lower weight from ESG Laggards (stocks rated CCC to B).⁵ Additionally, as stated earlier, the ESG Focus Indexes excluded stocks involved in tobacco and controversial weapons.⁶

The MSCI USA ESG Focus Index and the MSCI EAFE Focus Index are designed to balance equity investors' desire for an improved ESG profile while maintaining exposure to the equity market in order to seek the full equity premium. Optimizing the portfolio construction of the MSCI ESG Focus Indexes resulted in reduced tracking error and helped limit the differences in return between the indexes and their parent market-cap-weighted indexes.

⁵ Stocks rated AA to AAA are equivalent to ESG score ratings of 7.1 – 10.0 and stocks rated B to CCC are equivalent to ESG score ratings of 0.0 to 2.9.

⁶ MSCI has also developed the MSCI Extended ESG Focus Indexes, which exclude tobacco and controversial weapons companies, as well as those that produce or have ties with civilian firearms.

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